TRIMMING THE HEDGES: WHY THE ADOPTION OF WACHTELL, LIPTON, ROSEN AND KATZ'S ANTI-GOLDEN LEASH BYLAW IS ILL-ADVISED

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> *"Today shareholder activism is ripping through the boardrooms of public corporations and threatening the future of American business."*[1]

I. ABSTRACT

Question: Should publicly traded corporations pass bylaws prohibiting activist investors from nominating and paying persons to run for the board? This Note explores this question and ultimately concludes that corporations should resist adopting such bylaws.

II. INTRODUCTION

The rising prevalence of shareholder activism is evidenced in the news articles scattered throughout *The Wall Street Journal* and *New York Times*. Studies suggest that shareholder activists are flexing more and more muscle[2] in an attempt to initiate change within under performing corporations, all with an eye toward value maximization. Activists, for example, have recently successfully demanded the disbursement of special dividends to shareholders when corporations accumulate enormous amounts of cash.[3]

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[1] Gretchen Morgenson, *Memo to Shareholders: Shut Up*, N.Y. TIMES, Feb. 11, 2007, at EU1 (quoting Martin Lipton, Partner, Wachtell, Liption, Rosen & Katz, Keynote Address to 25th Annual Institute on Federal Securities, (Feb. 7, 2007)).

[2] *See* SCHULTE ROTH & ZABEL, SHAREHOLDER ACTIVISM INSIGHT (2012).

[3] *See* Noah Buhayar & Zachary Tracer, *Einhorn Boosts Apple Stake, Praises Capital-Return Plan*, BLOOMBERG (May 7, 2013, 4:21 PM), http://www.bloomberg.com/news/2013-05-07/einhorn-boosts-apple-stake-praises-capital-return-plan.html. Apple issued a special fifteen-percent increase dividend disbursement, in part, because of efforts made by hedge fund manager David Einhorn. *Id.*

For many of these targeted corporations, stock value and overall profitability have soared above pre-activist levels.[4] One way in which activists advocate for change is through the removal and/or appointment of new directors. Activists have offered to pay highly qualified individuals to run for a target's board and, if elected, continue to compensate those individuals based on corporate or hedge fund performance (known as "golden leash" payments). For activist-nominated directors, there exists an incentive to push for riskier corporate behavior in order to increase such compensation. The question becomes whether activists are merely concerned with quick, short-term profits to the detriment of the long-term interests of the remaining shareholders. As activists can initiate corporate change with only a minority stake, this is a real concern.

This Note explores the topic of shareholder activism. Part III defines crucial terminology and describes how activists initiate corporate change. Part IV focuses on the fiduciary duties directors owe to shareholders and questions whether a legally recognized fiduciary duty should exist for activists in the interest of the remaining shareholders. These fiduciary duties are examined under the current Delaware corporate law. Part V examines the recent proxy battles between the Hess Corporation and Elliott Management and other similar instances like Jana Partners and Agrium, Inc., as they provide an appropriate segue into the discussion of whether corporations should be permitted to prohibit activists from nominating and paying individuals to run as corporate directors. In Part VI, this Note ultimately concludes that such activism, to a certain extent, is beneficial to a corporation. Absent the emergence of concrete evidence suggesting activists harm their target corporation's long-term growth, bylaws prohibiting activist-compensated directors would be contrary to public policy.

III. TERMINOLOGY & DISCUSSION

A. *Hedge Funds*

A hedge fund is a pooled investment fund that utilizes aggressive strategies to obtain higher returns. Hedge funds generally charge high fees. Additionally, hedge funds generally receive twenty percent of the positive earnings generated from the investment. Thus, unlike mutual fund managers, hedge fund managers have an added incentive to make especially risky bets since high risk can lead to higher returns. Hedge funds are not generally required to make substantial public disclosures. They also are not permitted to market themselves or accept public money. Consequently, only accredited entities or wealthy individuals can invest in hedge funds.

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[4] *See* James Surowiecki, *When Shareholder Activism Goes Too Far*, NEW YORKER (Aug. 15, 2013), http://www.newyorker.com/online/blogs/currency/2013/08/when-shareholder-activism-goes-too-far.html.

As hedge funds tend to be more risk acceptant, problems can arise when they invest substantially in corporations. Target corporations' management and boards of directors experience headaches attributable to hedge fund money managers. Hedge funds can implement certain strategies designed to increase the corporation's share price. Whether or not these affect the corporation's long-term financial stability is a question discussed later. For now, it is worth understanding how hedge fund managers administer their moneymaking strategies.

B. *Shareholder Activism*

Shareholder activism is the exertion of minority shareholder rights with the goal of obtaining a high share value.[5] Hedge fund money managers often play the role of shareholder activists. Activists take "sizeable (though usually minority) stakes in undervalued or struggling companies and then agitat[e] for change. That change-seeking has typically focused on management—replacing C.E.O.s or board members—or on what's usually called 'financial engineering': pushing companies to buy back shares, raise dividends, sell off underperforming divisions, and so on."[6]

Activists also have the ability to launch proxy campaigns or threaten lawsuits to remove directors. However, both of these avenues tend to be exorbitantly expensive. In this context, a proxy is a document that contains the corporation's relevant business information. Corporations are required to file proxy statements to their shareholders prior to each annual shareholder meeting. Proxies can contain anything from the CEO's salary and benefit package to shareholder proposals.

Because the SEC does not permit shareholders to campaign for directors on the corporation's proxy statement, shareholders wishing to do so generally must create their own proxy. Essentially, this entails gathering the desired information and mailing it out to each individual shareholder. Proxy battles tend not to be an especially efficient way to unseat directors or initiate change. As will be discussed below, litigation also suffers from the same inefficacies and, as a result, is not a highly utilized form of transformation.

Activist shareholders typically target underperforming, undervalued corporations. Their ability to effectuate change begins with the purchase of equity in those target corporations. Strategy plays a role in the accumulation of such equity, as activists have the option to purchase a certain percentage of a corporation without having to disclose the transaction. SEC rules mandate shareholders file a Schedule 13D when their interest in a corporation reaches a five percent stake; after the five percent ceiling is

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5 *See* Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 56 (2011).

6 *See* Surowiecki, *supra* note 4.

surpassed, shareholders still have ten days to report their interest.[7] Ultimately, this allows activists to manipulate the timing of their purchase to their advantage.

To be sure, activism takes many forms. There are instances in which activists take rather modest avenues through open communication with directors and officers. Other times, activists effectuate change by being an absolute nuisance through proxy battles and litigation. A proxy battle occurs when activists motivate other dissatisfied shareholders in an effort to join forces to effectuate change in corporate governance. Proxy battles can focus energy toward removing directors and officers or forcing alterations in a corporation's articles and bylaws. Activists often see a change in the board as an effective way to obtain the desired results. Martin Lipton compiled a more complete list of devices used by activists on a Harvard Law School blog, including:

- (a) proposing a precatory proxy resolution for specific actions prescribed by the activist or the creation of a special committee of independent directors to undertake a strategic review for the purpose of "maximizing shareholder value";
- (b) conducting a proxy fight to get board representation (note solicitation for a short slate is very often supported by ISS and when it is, is usually successful) at an annual or special meeting or through action by written consent;
- (c) orchestrating a withhold the vote campaign;
- (d) aggressively criticizing and opposing a company's announced initiatives and strategic actions;
- (e) seeking to force a sale by leaking or initiating rumors of an unsolicited approach, publicly calling for a sale, acting as an (unauthorized) intermediary with strategic acquirers and private equity funds or making their own "stalking horse" bid;
- (f) rallying institutional investors and sell-side research analysts to support the activist's program;
- (g) using stock loans, options, derivatives and other devices to increase voting power beyond the activist's economic equity investment;
- (h) using sophisticated public relations and media campaigns to advance the activist's arguments;

[7] Filing of Schedules 13D and 13G, 17 C.F.R. § 240.13D (2013); *see also Schedule D*, SEC, http://www.sec.gov/answers/sched13.htm (last visited Apr. 15, 2014).

- (i) hiring private investigators to establish dossiers on directors, management and key employees and otherwise conducting aggressive "diligence"; and
- (j) litigating to obtain board records and materials and to block transactions.[8]

Further, Lipton warns that defending against shareholder activism is "an art, not a science."[9]

Opponents of shareholder activism argue activist-nominated directors will be more amenable to the activist's suggestions. Hedge fund managers, on the other hand, highlight that directors owe fiduciary duties to the shareholders. Also, once the arrangement is made, hedge fund managers are contractually obligated to fulfill their side of the contract so the activist-nominated directors no longer have a direct connection to the hedge fund.

C. *Increase in Shareholder Activism*

The prevalence of shareholder activism has increased over the past few decades. Money manager Martin Sosnoff recounts activism in the 1980s: "I essayed corporate activism in the eighties when it was notably unfashionable for a money manager to do so. You were expected to sell problematic stocks rather than tussle with mediocre management and go for control. Clients gave me a hard time, even a scolding."[10] Times have changed. The recent financial crisis has frustrated investors more willing to become involved in those tussles. In a shareholder activism report issued by the law firm Schulte Roth & Zabel, a shareholder activist explained, "[p]oor corporate governance is the cause of concern and the main reason behind increasing shareholder activist activity. Even the largest corporations, which were once pioneers of management and decision making, have witnessed constant change in top level management."[11] Data collected from 1994–2007 shows an exorbitant *quantitative* increase in 13D filings by activist hedge funds. In 1994, there were only ten 13D filings; in 2007, there were 272.[12]

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[8] Martin Lipton, *Dealing With Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 21, 2013, 12:24 PM), http://blogs.law.harvard.edu/corpgov/2013/11/21/dealing-with-activist-hedge-funds-2/.

[9] *Id.*

[10] Martin Sosnoff, *Shareholder Activism Is a Shabby Myth*, FORBES (Sept. 5, 2013, 3:49 PM), http://www.forbes.com/sites/martinsosnoff/2013/09/05/shareholder-activism-is-a-shabby-myth/.

[11] *See* SCHULTE ROTH & ZABEL, *supra* note 2, at 8.

[12] Lucian A. Bebchuk et al., *The Long-term Effects of Hedge Fund Activism* 3 (Columbia Business School Research Paper No. 13-66, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2291577.

The question remains: however, whether there has been a *qualitative* increase in the intervention. That is, whether activists have made a more aggressive push for the implementation of their policies. The evidence suggests this, too, has experienced a similar expansion. In the Schulte report, a private equity investor explained that activists have "intensified their corporate governance activities and are trying to establish themselves as sophisticated players in the investment community while attempting to gain greater involvement in strategic corporate decisions and control in decision making."[13] For shareholder activists, the ability to control how the target operates its business is often essential to realizing high returns on their investments.

One author writes, "hedge funds with significant shareholdings have been able to use wolf-pack tactics against companies to achieve at least some of their aims."[14] Hedge fund activity in a particular target corporation can attract more hedge fund managers to that same target. This has its advantages. It further aligns activists, bringing together their shared interest in high returns and greater profits. Additional hedge funds mean greater power to effectuate change. Also, these "wolf-pack tactics" allow hedge funds the ability to remain under the radar. An individual hedge fund may buy less than a five percent interest in the target and, thus, does not have to file a 13D. Essentially, "[t]his kind of close but non-group forming pseudo-cooperation . . . shows how intimate shareholders can get without running afoul of the rules."[15] Wolf-pack tactics enable multiple hedge funds to invest in the same target corporation without having to disclose their activity. Imagine a scenario in which three, four or five hedge funds each take sizeable stakes in one target corporation. This 13D bypass is empowering. This provides activists a sizeable stake in the target. Assuming three, four or five hedge funds pooled together (if each remained just below the five percent threshold), this respectively equates to a fifteen, twenty or twenty-five percent interest in the target. With such substantial stakes, if the hedge funds aligned their goals, they could instigate enormous change within the target. Such high percentages would, in certain instances, make the hedge funds the majority shareholder. Power exists in numbers—a concept not lost on hedge fund money managers.

This brings into question *how* activists exert their power in corporate governance. There are a variety of different ways activists initiate change. First, "[c]ommunication between shareholders and management remains the most effective method for activists to achieve their goals."[16] Open dialogue has the advantage of potentially being less confrontational

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[13] *See* SCHULTE ROTH & ZABEL, *supra* note 2, at 4 (quoting a private equity investor).

[14] Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 721 (2007).

[15] *Id.* at 698.

[16] *See* SCHULTE ROTH & ZABEL, *supra* note 2, at 7.

and more amicable, allowing for greater efficiency. At times, activists often have a greater chance of getting their way if they approach the intervention in a more diplomatic fashion. Chris Cernich, head of the M&A proxy-contest research at Institutional Shareholder Services, claims, "'The least effective way to do activism these days is to come in with a big club.'"[17] However, in the case of Elliott Management and Jana Partners (discussed below), communication was not effective. In those instances, bitter fights over control of the target ensued. The question remains what happens when neither party is interested in communicating with the other side.

In the event communication fails, an activist has more aggressive, more expensive avenues available. An activist may, for instance, choose to launch a public campaign in opposition against the board of directors or commence a proxy battle. However, these are becoming less prevalent as they can be very expensive and time consuming. Bill Ackman acknowledges that "'[n]obody wants to have a public battle . . . We prefer to work with boards in making changes that increase shareholder value, but sometimes you have to go to the mat.'"[18] Given that Ackman estimates his Canadian Pacific proxy battle cost him up to fifteen million dollars,[19] it is no wonder that open, *free* communication with the board is preferred.

Diane Brady, a senior editor for *Businessweek*, believes that the increase in shareholder activism is aided by a change in the public's attitude.[20] She writes, "[a]ll the tools once used to avert activists in the boardroom, from poison pills that avert takeovers to golden parachutes that enrich management, are seen as negatives for shareholders. Outrage over executive compensation, cozy boards, and lax oversight has also shifted views of activism."[21] The public's tolerance, however, only goes so far. Brady concedes, "[m]any investors remain wary about both the motives and the techniques of those seeking big changes in pursuit of big profits."[22]

Another tactic hedge fund activists deploy involves direct representation on the target's board of directors. If a hedge fund successfully gains direct board representation, the approach changes.[23] Such direct representation will be discussed later, using Hess Corporation and Elliott Management as an example. For now, it is worth noting the strategies activists may employ in order to increase their value. First, activists can reduce the target's cash by increasing its leverage and pay

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[17] Diane Brady, *The Good Barbarian: How Icahn, Ackman, and Loeb Became Shareholder Heroes*, BUSINESSWEEK (May 14, 2012), http://www.businessweek.com/articles/2012-05-14/the-good-barbarian-how-icahn-ackman-and-loeb-became-shareholder-heroes.
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *See* Briggs, *supra* note 14, at 717.

higher or special dividends.[24] For example, David Einhorn recently argued that Apple should issue a dividend disbursement to its shareholders or disburse a new preferred stock.[25] At one time, Apple had more than $144.7 billion[26] available and Einhorn believed the shareholders were owed a portion.[27] The second common tactic utilized by activists involves lowering the target's capital expenditures, as well as their research and development expenditures.

Regardless of why activism has proliferated, the fact remains that there has been an increase in such activism. There also remains a very real divide as to whether activism is financially beneficial or detrimental for a target's long-term shareholders. The Note now addresses this issue.

D. *Shareholder Activism Critics*

Critics of shareholder activism point to the idea of myopic returns. Essentially the belief is that "improved performance following activist interventions comes at the expense of sacrificing performance later on, and short-term positive stock reactions merely reflect inefficient market prices that are moved by the short-term changes and fail to reflect their long-term costs."[28] As one of the arguments goes, the markets immediately react to the announcement of hedge fund investment in the target. This positive reaction artificially inflates the target's stock price above the true value of the corporation. When the dust settles, the target's shareholders are left with overvalued stock that will inevitably drop, whether for reasons of natural stock market correction or for reasons more directly related to the hedge fund's future activity. Examples of activism that are detrimental to the target's health follow.

One problem, critics argue, is that activists are capable of manipulating corporate governance in a way that favors quick returns.[29] For example, as discussed above, activists have successfully forced targets to

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[24] April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors* 4 (NYU Law & Econ. Research Paper No. 06-41, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913362.
[25] AppleInsider Staff, *Hedge Fund Manager David Einhorn Sues Apple Over $137B Cash Hoard*, APPLEINSIDER (Feb. 7, 2013, 11:30 AM), http://appleinsider.com/articles/13/02/07/hedge-fund-manager-david-einhorn-sues-apple-over-137b-cash-hoard.
[26] Steve Schaefer, *Paging David Einhorn: Apple Hikes Dividend, Supersizes Buyback as Cash Swells to $145B*, FORBES (Apr. 23, 2013, 5:55 PM), http://www.forbes.com/sites/steveschaefer/2013/04/23/paging-david-einhorn-apple-raises-dividend-ups-buyback-as-cash-swells-to-145b.
[27] Michael J. de la Merced, *Einhorn Supports Apple's Big Payouts*, N.Y. TIMES DEALBOOK (Apr. 23, 2013, 6:57 PM), http://dealbook.nytimes.com/2013/04/23/einhorn-supports-apples-big-payouts/?_php=true&_type=blogs&_r=0.
[28] *See* Bebchuk et al., *supra* note 12.
[29] *See generally id.*

disburse special, unplanned dividends.[30] Critics argue that intervention such as this puts the target's long-term health at risk because those funds, instead, should be held for potential investing or for further research and development.[31] One opponent remarked, "To build wealth in a durable manner, corporations need to commit capital to long-term endeavors, often involving a lag time between the investment of capital and the achievement of profit, a long time during which activities like research and development occur."[32] Shareholder activism threatens this durability.

Critics also argue that shareholder-activist intervention imposes an unstable "democratic" approach to corporate governance.[33] Delaware Chancellor Leo Strine believes that if

> corporations become direct democracies, where every action of management is the subject of a stockholder plebiscite, the time and attention of managers will be increasingly diverted from profit-producing activities into more "political" activities centered on addressing referenda items propounded by particular stockholders, who often have no long-term commitment to remaining as stockholders and who owe other stockholders no fiduciary duties.[34]

Critics such as Chancellor Strine argue that corporations must resemble more of a republic in order to fully benefit from the board's expertise and insight.[35] That is, boards and officers have clearly distinct roles and their ability to carry forward their plan uninterrupted, subject to their fiduciary duties, is critical for a corporation's long-term health. Simply, corporate law vests managerial power to the board of directors—not the stockholders.[36]

A transformation in this paradigm disrupts the board's ability to remain attentive to shareholder interests. Shareholder activism shifts the *power* from the board to a more limited body (i.e., hedge fund money managers) without the *legal responsibility* to the remaining parties.[37] Critics argue that activists proffering long-term corporate governance strategies should have a substantial long-term incentive to keep their interests properly aligned with the remaining stockholders. The liquidity of publicly traded stock opens the avenue for activists to "pump and dump." That is,

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[30] *See generally* Klein & Zur, *supra* note 24.

[31] *See, e.g.*, Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 3 (2010).

[32] *Id.*

[33] *See generally id.*

[34] *Id.* at 4.

[35] *See generally id.*

[36] *Id.*

[37] *See* discussion *infra* Part IV.

activists can invest their money short term, enact short-term strategies, watch the stock price soar and then sell off their interest without regard to the long-term finances of both the corporation and the remaining stockholders.

1. *Negative Examples of Shareholder Activism*

There have been instances that activists push for even more change. Activist Bill Ackman has taken particularly tenacious approaches. His handling of Target and JCPenney evidences his hands-on approach.[38] Ackman heads Pershing Square Capital Management, a company managing "pooled investment vehicles for high net worth individuals and institutional investors"[39] with a portfolio value of approximately twelve billion dollars.[40]

In 2007, Ackman invested approximately two billion dollars in Target, the well-known retailer.[41] Then a three percent owner of the company, Ackman launched a proxy campaign to replace five incumbents with other candidates—including himself.[42] The proxy battle came as a surprise to many on Wall Street as Target was then "the only major retailer [thriving] while going head to head with one of the world's most formidable companies: Wal-Mart Stores."[43] The company battled back and, ultimately, none of Ackman's nominated candidates were elected.[44]

Throughout this process, Ackman's portfolio took a loss. Ninety percent of his initial two billion dollar investment was lost as Target's share price plummeted fifty percent.[45] When Ackman originally purchased equity in Target, the price per stock was approximately $60.17.[46] Ackman finally sold all of his interest in Q1 of 2011—shares traded around $56.75.[47] Though Ackman's portfolio, on a broader scale, boasts success, his endeavor in Target certainly did not show the return he originally imagined.

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[38] *See* Joe Weisenthal, *Bill Ackman Wants Everyone Who Says He's a Destroyer of Companies to See This Chart*, BUS. INSIDER (Aug. 21, 2013, 4:25 AM), http://www.businessinsider.com/performance-of-bill-ackman-activist-investments-2013-8.
[39] *See generally id.*
[40] *William Ackman*, FORBES, http://www.forbes.com/profile/william-ackman/ (last updated Apr. 16, 2014, 8:55 PM).
[41] Katherine Burton, *Ackman Seeks to Raise Fund for Unnamed Activist Stake*, BLOOMBERG (Jul. 8, 2013, 7:21 PM), http://www.bloomberg.com/news/2013-07-08/ackman-raises-money-for-activist-stake-in-large-company.html.
[42] Andrew Bary, *Ackman's Target Campaign Is Off-Target*, BARRON'S (May 25, 2009, 11:59 PM), http://online.barrons.com/article/SB124303588507648835.html.
[43] *Id.*
[44] Bill Catlin, *Target Shareholders Reject Ackman's Board Slate*, MPR NEWS (May 28, 2009, 5:23 PM), http://www.mprnews.org/story/2009/05/28/target_shareholders_reject_ackman.
[45] *Id.*; *see also* Weisenthal, *supra* note 38.
[46] *See* Weisenthal, *supra* note 38.
[47] *Id.*

Ackman suffered similar woes with his aggressive campaign in JCPenney. Ackman originally purchased JCPenney stock in Q3 of 2010[48] when the shares were trading at twenty-five dollars.[49] He spearheaded the campaign to bring in Ron Johnson, former Apple retail chief, as CEO. During Johnson's seventeen-month stint as JCPenney's CEO, sales fell twenty-five percent and the company netted a loss of 985 million dollars.[50]

Skeptics of Ackman claim his handling of the retailer ruined the corporation and, as a result, destroyed jobs.[51] One critic noted, "Instead of simply focusing on financial engineering, he set out to remake the entire business, giving it a new strategic direction, revamping its stores, and changing its customer base."[52] JCPenney's extensive transformation was fueled by Ackman's vision.[53] Despite his critics, Ackman claimed, "As the largest shareholder of JCPenney, I only have one goal: help save one of the great iconic American companies."[54] He was unsuccessful; he recently dumped all of his 39.1 million shares of JCPenney for $12.90 a share, resulting in an approximate loss of 473 million dollars.[55] After the sale, the market responded, adding insult to injury: JCPenney stock witnessed a 4.1% gain.[56]

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[48] *Buy/Sell Activity: Bill Ackman - Pershing Square Capital Management* DATAROMA, http://www.dataroma.com/m/m_activity.php?m=psc&typ=a&L=2 [hereinafter DATAROMA] (last visited Apr. 16, 2014).

[49] *See* Michael J. de la Merced, *His Links Severed, Ackman Sells Stake in J.C. Penney*, N.Y. TIMES DEALBOOK (Aug. 26, 2013, 5:22 PM), http://dealbook.nytimes.com/2013/08/26/ackman-moves-to-sell-stake-in-j-c-penney/.

[50] Abram Brown, *J.C. Penney Is Awash in Red Ink: $552 Million Q4 Loss and Customer Flight*, FORBES (Feb. 27, 2013, 6:56 PM), http://www.forbes.com/sites/abrambrown/2013/02/27/j-c-penney-posts-wider-than-expected-552-million-loss-holiday-sales-fell-28/. The Johnson era was so negative that JCPenney actually released a commercial apologizing to its customers. *See* Clare O'Connor, *J.C. Penney Releases Apology Ad Begging Shoppers to Come Back*, FORBES (May 1, 2013, 2:49 PM), http://www.forbes.com/sites/clareoconnor/2013/05/01/j-c-penney-releases-apology-ad-begging-shoppers-to-come-back/.

[51] *See* Weisenthal, *supra* note 45.

[52] *See* Surowiecki, *supra* note 4.

[53] *Id.*

[54] *See* Suzanne Kapner & Emily Glazer, *Investor William Ackman Targets J.C. Penney's CEO*, WALL ST. J. (Aug. 8, 2013, 9:33 PM), http://online.wsj.com/news/articles/SB10001424127887323477604579000691399643208.

[55] *See* Emily Glazer et al., *Ackman Moves to Dump Entire Stake in J.C. Penney*, WALL ST. J. (Aug. 26, 2013 8:21 PM), http://online.wsj.com/news/articles/SB10001424127887324591204579037251135114142.

[56] *See* David Benoit, *With Ackman Gone, J.C. Penney Enjoys One of Best Days of 2013*, WALL ST. J. (Aug. 27, 2013, 12:39 PM), http://blogs.wsj.com/moneybeat/2013/08/27/with-ackman-gone-j-c-penney-enjoys-one-of-best-days-of-2013/?KEYWORDS=ackman+jcpenney.

E. *Shareholder Activism Advocates*

On a broader scope, advocates argue shareholder activism increases shareholder returns by encouraging targets to better manage their assets. Specifically, Lucian Bebchuk, Alon Brav and Wei Jiang answered Lipton's challenge by authoring an article providing the first empirical analysis of activists' effects on long-term profitability.[57] Their regressions provide that shareholder activism actually increases both short- and long-term value.[58] Because critics argue shareholder activists spike current share prices to the detriment of long-term growth, the authors especially focused on such claim.[59] They conclude, "[w]e find no evidence that interventions are followed by declines in operating performance in the long term; to the contrary, activist interventions are followed by improved operating performance during the five-year period following these interventions."[60]

The authors concede the critics are correct about one thing: shareholder activist intervention tends to create an initial upward surge in the target's stock price.[61] Their findings suggest that "[t]here is evidence that Schedule 13D filings—public disclosures of the purchase of a significant stake by an activist—are accompanied by significant positive price reactions as well as subsequent improvements in operating performance."[62] The mere announcement of a shareholder activist staking a claim in the target company produces approximately a six percent increase in stock price.[63] Other studies indicate similar stock tendencies. For instance, one paper found that hedge fund activism earns a 10.2% average abnormal stock return during the period immediately following a Schedule 13D filing.[64] Further, the authors found that targeted companies earned an additional 11.4% of abnormal returns a year following the Schedule 13D filing.[65] These positive finds are consistent with Bebchuck, Brav and Jiang though they only extend a year following the initial activism.[66]

Critics and advocates draw entirely different conclusions from these results. For instance, critics like Lipton dismiss the stock spikes as insignificant.[67] Opponents argue that the initial stock price increase is more than cancelled out by the negative long-term returns, leaving the remaining shareholders out of luck.[68] However, not only do the authors find no

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57 *See* Bebchuk et al., *supra* note 12.
58 *See generally id.*
59 *Id.*
60 *Id.* (in Abstract).
61 *Id.* at 16.
62 *Id.* at 2.
63 Bebchuk et al., *supra* note 12, at 16.
64 *See* Klein & Zur, *supra* note 24, at 44.
65 *Id.* at 3.
66 *See generally* Bebchuck et al., *supra* note 12.
67 *See generally* Lipton, *supra* note 8.
68 *See* Bebchuk, *supra* note 12, at 17.

evidence of activist-caused declines in long-term performance, they find "clear patterns of improved operating performance relative to industry peers during the five years following activist interventions."[69] Thus, targeted shareholder activist companies are actually *outperforming* other companies within the same industry during the five-year period.

1. *Positive Examples of Shareholder Activism*

To be fair, Ackman's successes greatly outnumber his failures. In 2005, Ackman invested in McDonald's Corporation.[70] The stock traded at \$28.98 the day before his initial acquisition.[71] As of March 17, 2014, McDonald's stock trades at \$97.60.[72] Similarly, Ackman's investment in Procter & Gamble Co. was prosperous. The stock traded at \$64.51 the day before his initial acquisition in May 4, 2012.[73] As of March 17, 2014, P&G stock trades at \$79.84, over a twenty-three percent increase in under two years.[74] Recently, Ackman's Pershing Square sold a majority of its interest in P&G.[75] Before Pershing Square dumped a majority of its stock, Ackman agitated change within the company. He "successfully pushed for the changes, and shares reacted favorably, scoring him a big win."[76] Among these changes was Ackman's ability to replace P&G's CEO Robert McDonald with A.G. Lafley.[77]

The stock prices of General Growth Properties are especially revealing. Ackman originally invested in the company in 2008 when the stock price traded at \$0.35 per share.[78] As of March 17, 2014, the stock trades at \$20.74.[79] Though causation cannot be logically discerned from these interactions, the correlation is nonetheless impressive. Ackman still

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[69] *Id.* at 10.
[70] Chris Burritt & Katherine Burton, *Bill Ackman Sells McDonald's Stake After Stock Surges (Update4)*, BLOOMBERG (Dec. 5, 2007, 4:08 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aZ6kcnn5qqUo.
[71] *See* Weisenthal, *supra* note 38.
[72] *McDonald's Corporation*, NYSE EURONEXT, http://www.nyse.com/about/listed/lcddata.html?ticker=mcd (last visited Mar. 17, 2014).
[73] *See* Weisenthal, *supra* note 38.
[74] *Procter & Gamble Co.*, NYSE EURONEXT, http://www.nyse.com/about/listed/pg.html (last visited Mar. 17, 2014).
[75] *See* DATAROMA, *supra* note 48.
[76] David Benoit, *Pershing Square Cuts Size of Procter & Gamble Common Stake by 76%*, WALL ST. J. (Nov. 14, 2013, 6:07 PM), http://blogs.wsj.com/moneybeat/2013/11/14/pershing-square-cuts-size-of-procter-gamble-common-stake-by-76/?KEYWORDS=ackman+procter.
[77] Jeremy Bogaisky, *Congrats, Bill Ackman: Bob McDonald Out at P&G, A.G. Lafley Returning as CEO*, FORBES (May 23, 2013, 6:57 PM), http://www.forbes.com/sites/jeremybogaisky/2013/05/23/bob-mcdonald-out-at-procter-a-g-lafley-returning-as-ceo/.
[78] *See* Weisenthal, *supra* note 38.
[79] *General Growth Properties*, NYSE EURONEXT, http://www.nyse.com/listed/ggp.html (last visited Mar. 17, 2014).

maintains an interest in General Growth, but Pershing Square's absolute interest is decreasing. What is interesting is that, consistent with Bebchuk, Brav and Jiang's finding, Ackman's successful interventions have not led to material declines in stock price as his interest diminishes. Perhaps not enough time has passed for negative consequences to surface, but as of yet, the target companies appear stable.

IV. FIDUCIARY DUTIES

1. *Fiduciary Duties Directors Owe to Shareholders*

Hedge fund activists target companies organized in the corporate form. The corporate structure allows ordinary investors to buy a limited-liability interest in the company. Thus, the owners (the shareholders) and the management (directors and officers) are separate entities. For this reason, there exist fiduciary duties that help police and, ideally, ensure that management acts in the interest of the shareholders.[80] Generally, these fiduciary duties include a duty of loyalty and care, which prevent management from engaging in self-dealing transactions that serve to benefit the directors and officers rather than the shareholders.[81] Avoiding these forms of self interest is at the heart of why fiduciary duties exist.[82] What these duties entail and how they are applied is an essential element to this Note. Decades of case law elucidates where courts generally find shareholders are protected. As will be discussed, the business judgment rule often serves as management's greatest defense against breach of fiduciary duty claims.[83]

The business judgment rule serves to insulate management from overly extensive liability.[84] The business judgment rule provides a judicial presumption that the directors have acted in accordance with their fiduciary duties of care, loyalty and good faith.[85] This rule allows directors to make business decisions they truly believe will benefit the company.[86] Such decisions often involve risk, and the business judgment rule curbs certain litigation, allowing management to take a necessary amount of risk.[87]

As mentioned, the business judgment rule provides a presumption of lawful behavior.[88] Thus, the burden of proof rests on the shareholder to

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[80] *See* Lori McMillan, *The Business Judgment Rule as an Immunity Doctrine*, 4 WM. & MARY BUS. L. REV. 521, 524 (2013).
[81] *Id.* at 531–33.
[82] *See id.* at 531.
[83] *See generally id.*
[84] *See id.* at 521.
[85] *See id.* at 524.
[86] *See id.* at 565.
[87] *See id.* at 565–66.
[88] *See generally id.*

demonstrate that management acted to the contrary of such presumption.[89] In *Shlensky v. Wrigley*, the court held that absent a showing of "fraud, illegality or conflict of interest," the business judgment rule applies.[90] This holding indicates the difficulty shareholders may have in overcoming the business judgment rule.

For example, in *Shlensky*, the shareholders sued the directors of Chicago National League Ball Club, Inc. for failing to install lights at Wrigley Field. Without lights, the Chicago Cubs were unable to hold night games during the week. The plaintiffs argued this resulted in lower attendance during the week and, consequently, lower profits. The plaintiffs also alleged that the defendant "refused to install lights, not because of interest in the welfare of the corporation but because of his personal opinions 'that baseball is a 'daytime sport' and that the installation of lights and night baseball games will have a deteriorating effect upon the surrounding neighborhood.'"[91] Thus, the directors admitted their decision was not based upon the financial wellbeing of the corporation; rather, the directors believed their decision would benefit the corporation in other ways. Nevertheless, the court ruled that the business judgment rule protected the directors because the shareholders failed to establish the directors' decision was colored with "fraud, illegality or conflict of interest."[92] This decision suggests the business judgment rule protects management to a high degree.

Although the business judgment rule insulates management very well, management must consider shareholders before the interests of any other constituencies. In *Dodge v. Ford Motor Company*, the court ruled on exactly this issue.[93] Henry Ford refused to issue a dividend to the shareholders, claiming he wanted to use the money to invest in additional machinery as well as share the company's earnings with the general public.[94] His strategy unarguably lowered the company's profits. Ford wanted to continue Ford Motor Co. "as a semi-eleemosynary institution and not as a business institution."[95] The court held:

> [I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no one will contend that, if the avowed purpose of the defendant

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[89] *See id.* at 529–30.
[90] 237 N.E.2d 776, 780 (Ill. App. Ct. 1968).
[91] *Id.* at 778.
[92] *Id.* at 780.
[93] 170 N.W. 668 (Mich. 1919).
[94] *Id.* at 671.
[95] *Id.* at 683.

> directors was to sacrifice the interests of shareholders, it would not be the duty of the courts to interfere.[96]

Though this decision does not specifically rule on the business judgment rule, it does illustrate that a corporation's management must act within a certain legal boundary. In essence, the shareholder constituency is of primary concern—even if finances are not a decision's driving factor.

Relevant to the discussion then is the fiduciary duty of care. In *Joy v. North*,[97] the Second Circuit Court of Appeals wrote, "the business judgment rule extends only as far as the reasons which justify its existence. Thus, it does not apply in cases . . . in which the corporate decision lacks a business purpose, . . . [or] is tainted by a conflict of interest."[98] The "tainted by a conflict of interest" is especially pertinent to the discussion of hedge fund-appointed directors. For now, the duty of care is discussed in the traditional sense.

The issue of decisional duty of care was discussed in *Smith v. Van Gorkom*.[99] In this case, shareholders brought suit against the directors, claiming they failed to accurately determine the company's value prior to sale.[100] The corporation's directors relied almost exclusively on Van Gorkom, the chairman and CEO.[101] The court determined the concept of gross negligence was the standard applicable to decisional duty of care.[102] The court then found the directors breached this duty because they "(1) did not adequately inform themselves . . . (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the 'sale' of the Company upon two hours' consideration."[103] Thus, the court determined the directors could not rely on the protection of the business judgment rule because they did not base their decision on sufficient facts.[104]

Since the *Van Gorkom* decision, however, statutes were amended to limit its scope. The Delaware General Corporation Law (DGCL) section 141 was altered to further protect directors, stating in pertinence:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or

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[96] *Id.* at 684.
[97] 692 F.2d 880 (2d Cir. 1982).
[98] *Id.* at 886 (internal citations omitted).
[99] 488 A.2d 858 (Del. 1985).
[100] *Id.* at 876.
[101] *Id.* at 877.
[102] *Id.* at 873.
[103] *Id.* at 874.
[104] *Id.* at 874, 888.

> statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.[105]

The extension of such permissible reliance is in accordance with the spirit of the DGCL. Indeed, Delaware's laws generally provide directors with a great deal of discretion.[106] Board protection allows directors to engage in riskier transactions that yield higher returns to the stockholders. Because stockholders have the ability to diversify their portfolios, they should, in theory, be financially capable of assuming more risk.

2. *Should Activist Shareholders Owe Fiduciary Duties to the Other Shareholders?*

As the above indicates, director-shareholder fiduciary duties are essentially set in stone. The more interesting question, then, is whether corporate law should recognize the increased prevalence of shareholder activism and adjust its law in the face of changed circumstances. As activists exert more control through unseating directors and replacing them with individuals of their choosing, the traditional corporate separation of ownership (shareholders) and managers (directors and officers) begins to deteriorate. This blurred distinction requires an examination into whether activists themselves should assume fiduciary duties to the remaining shareholders. The Note now turns to this issue.

Fiduciary duties are usually reserved for the directors and officers of the corporations. Courts have, however, held that certain types of shareholders also owe fiduciary duties to the remaining shareholders. For instance, "courts have held that majority shareholders, like corporate officers and directors, owe a fiduciary duty of loyalty to minority shareholders that precludes them from using their positions as controlling shareholders to extract material economic benefits from the firm at the minority's expense."[107] The California Supreme Court decided, "[a]ny use to which [majority shareholders] put the corporation or their power to control the corporation must benefit all shareholders proportionately."[108] A common example of majority shareholders forcing an issue is embodied in a freeze out. Freeze-out statutes vary by state. Pertinent to this Note is

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[105] DEL. CODE ANN. tit. 8, § 141(e) (2014).
[106] Marilyn French & Scott Mazur, *Leveraged Recapitalizations: There Is Such a Thing as Being Too Rich and Too Thin*, WEIL (Mar. 2004), http://www.weil.com/news/pubdetail.aspx?pub=8855.
[107] Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1265 (2008) (citations omitted).
[108] Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 471 (Cal. 1969).

DGCL section 253. Under DGCL section 253, a parent corporation owning at least ninety percent of a subsidiary may merge the subsidiary into the parent (an *upstream merger*).[109] The parent corporation does not need the subsidiary's consent for the merger.[110] The parent corporation's board also may execute the transaction without shareholder ratification.

In certain instances, these minority shareholders are not without remedy. If the squeezed-out minority shareholders do not like the price per share offered, they may seek relief by claiming the directors, officers or majority shareholders breached their fiduciary duty of loyalty:

> Freeze-outs present an obvious danger to minority shareholders because the controlling shareholder can use its position to effectuate the transaction at an unfairly low price. As an example, suppose a parent company seeks to acquire 100% of the equity of a partially owned subsidiary which it holds 60% of the outstanding shares. In such a case, the parent has an incentive to set the merger price as low as possible because every $1 reduction in the merger price saves the controlling shareholder $1 while costing the controlling shareholder only 60 cents. Courts have not hesitated to declare that controlling shareholders owe loyalty duties to minority shareholders in these circumstances and to subject freeze-outs to judicial scrutiny under the heightened standard of intrinsic fairness.[111]

The burden of proof is placed on the controlling shareholders to show the transaction is intrinsically fair.[112] Essentially, those majority shareholders "must prove to the court's satisfaction that the transaction took place at a 'fair price' and that it was accomplished through 'fair dealing.'"[113]

In addition to these fiduciary duties, minority shareholders, in certain instances, may also exert appraisal rights. Appraisal rights allow shareholders to challenge the consideration received for their stock as too low. Exercising appraisal rights can be effective. Greenlight Capital LLC was awarded a price 270% over the per share value of the original offered merger price.[114] Similarly, Prescott Group was awarded a 455% premium for their shares in The Coleman Company.[115] Other examples exist where

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[109] DEL. CODE ANN. tit. 8, § 253.
[110] *Id.*
[111] Anabtawi & Stout, *supra* note 107, at 1271–72 (citations omitted).
[112] *Id.* at 1264.
[113] *Id.* at 1266.
[114] *See* Joseph Glatt, *Is it Worth it? The Value of Delaware Appraisal Rights to the Activist Investor*, ACTIVIST INVESTING DEVELOPMENTS (Summer 2007), *available at* http://www.srz.com/files/News/ebd7562a-5d91-41ec-84c2-4b2b280f80dc/Presentation/NewsAttachment/fcf3914f-2885-4af4-b24a-23804876290f/filesfilesActivist_summer07_1_Is_it_worth_it.Glatt.pdf.
[115] *Id.*

simply threatening exercising appraisal rights led to an increase in the original consideration offered.[116] Unlike a derivative lawsuit, however, the corporation is not responsible for the attorney fees of shareholders seeking appraisal rights. An additional risk of exercising appraisal rights is that the Chancery Court can award the shareholder a price per share that is lower than the price originally offered.

These fiduciary duties, however, mostly relate to directors or officers that own a majority of the corporation's stock—instances most likely involving closely held corporations rather than public corporations. It is less clear how courts will rule if a minority shareholder such as a hedge fund exerts the power. For example, DGCL section 253 only pertains to majority shareholders that are directors and officers of the corporation.[117] No DGCL provision speaks specifically to minority control, leaving the uncertainty to case law. Minority shareholders who do not have a controlling vote may still be subject to fiduciary duties if they have the ability to exercise *de facto* control. The case law suggests, however, that those shareholders must "own[] enough voting shares to allow [them] to dictate membership on the board."[118]

In *In re Cysive, Inc., Shareholders Litigation*, the Delaware Chancery Court spoke to this issue.[119] The defendant owned roughly forty percent of the voting equity in the publicly traded company.[120] In determining whether the defendant was a controlling shareholder, then-Vice Chancellor Leo Strine found that had the defendant "become[] dissatisfied with the independent directors, his voting power position[ed] him well to elect a new slate more to his liking without having to attract much, if any, support from public stockholders."[121] Essentially, "the threat of 'inherent coercion' that [the defendant] presents to the independent directors and public stockholders of Cysive" indicated a controlling vote.[122]

Notably, this ordinarily does not pertain to hedge fund activists as they effectuate change without the clear voting power to do so. Although courts today would not likely deem hedge fund activists controlling shareholders, they nonetheless are able to control certain corporate actions. There always exists the possibility the Chancery may eventually hold that activists possess enough control to draw them into the "controlling shareholder" realm. As mentioned, activists have successfully campaigned for a director seat on numerous occasions. In no known case, however, have activists enjoyed enough power to "elect a new slate" of directors. Some

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[116] *Id.*
[117] DEL. CODE ANN. tit. 8, § 253 (2014).
[118] Anabtawi & Stout, *supra* note 107, at 1270.
[119] 836 A.2d 531 (Del. Ch. 2003).
[120] *Id.* at 535.
[121] *Id.* at 552.
[122] *See id.*

critics of hedge fund activism believe stricter laws should be set in place in order to alleviate what they believe is a problem.

Critics note that one detriment of hedge fund activism is "the problem of reining in minority shareholder opportunism in public corporations as shareholders become more powerful and more diverse."[123] Critics point out that hedge fund activists are nothing short of creative. Activists have thus far been able to elude strict corporate law limitations through adaptation and strategic innovation. As a response, some critics advocate that shareholders have latent fiduciary duties to one another. In particular:

> These latent duties would be triggered whenever a particular shareholder—whether or not it is technically a shareholder capable of controlling the boards' decisions as to all matters—in fact manages to successfully influence the company's actions with regard to a particular issue in which that shareholder as a material, personal economic interest. In other words, we believe that it is now time to expand both our notions of when a shareholder should be deemed to have "control" and our conception about the kinds of circumstances in which the exercise of that control poses a threat to the firm or to other shareholders.[124]

Thus, there are critics that believe fiduciary duties need an overhaul extension that would bring all shareholders into its restrictive rule.

This conclusion presupposes activism as adverse to a corporation's health. However, in *The Long-term Effects of Shareholder Activism*, the authors indicate quite the opposite.[125] Also, authors Anabtawi and Stout argue that "the duty of loyalty should be activated by *any* factual situation—including, but not limited to, freeze-outs and closely held corporations—in which a shareholder seeks to promote a corporate strategy or transaction in which that particular shareholder has a material, personal pecuniary interest."[126] This proposition is potentially dangerous for multiple reasons.

First, no comprehensive quantitative study exists that indicates hedge fund activism creates the adverse consequences feared by activism's critics. Given that activism is responsible for substantial increases in shareholder value, drastic measures altering current fiduciary duties are unwarranted and could therefore cause more harm than good. Second, this proposal would open the door for a substantial increase in shareholder litigation, as a majority of transactions are implemented with an eye toward

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[123] Anabtawi & Stout, *supra* note 107, at 1294.
[124] *Id.* at 1295.
[125] *See generally* Bebchuk et al., *supra* note 12.
[126] Anabtawi & Stout, *supra* note 107, at 1295–96.

financial gain. By its very nature, investment in a corporation gives rise to "personal pecuniary interest[s]"[127] for each and every shareholder.

It is nearly impossible to distinguish a shareholder's investment from anything other than a financial stake. For this reason, any dissatisfied shareholder could file a lawsuit against an active shareholder. An increase in litigation is problematic for a variety of reasons. If the burden of proof remains on the defendants and courts determine that intrinsic fairness applies (rather than the business judgment rule), a defendant could presumably only defeat those allegations *after* discovery.[128] Discovery expenses are certainly not nominal. With the possibility of costly discovery hanging over defendants' heads, undeserved settlements may proliferate. Courts have certainly been hesitant to expand allowable claims in areas of securities litigation, especially when opening up the gates subjects defendants to expensive discovery costs.[129] Nevertheless, the threat of such high discovery is a possibility if the Chancery or Delaware Legislature permits these types of actions to continue forward.

VI. ELLIOTT MANAGEMENT & JANA PARTNERS

Hess Corporation is "a leading global independent energy company primarily engaged in the exploration and production of crude oil and natural gas . . . and marketing petroleum products, natural gas and electricity."[130] As of April 15, 2014, Hess stock trades at $85.34 per share, making it the third-highest share price compared to other industry leaders such as Chevron ($119.38), Exxon Mobil ($97.34) and ConocoPhillips ($73.11).[131] As of that date, Hess's market capitalization was approximately twenty-six billion dollar.[132]

Earlier this year, the hedge fund, Elliott Management, voiced its dissatisfaction with Hess, claiming the corporation, under the guidance of the current board of directors, was underperforming relative to its peers.[133]

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[127] *Id.* at 1296.
[128] *See generally* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971). The intrinsic fairness test applies if there is a controlling or dominating shareholder in transactions such as freeze outs. *See id.* at 720. However, it is unclear whether this test would apply to an activist shareholder that holds less than a quantitatively controlling amount. The intrinsic fairness test requires both fair dealing and a fair price to minority shareholders in such a transaction. *See id.* at 717.
[129] *Cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952). Though these cases pertain to Rule 10b-5 claims for fraud, the overall sentiment is relevant to the instant issue.
[130] *Investors*, HESS, http://www.hess.com/investors/default.aspx (last visited Apr. 16, 2014).
[131] *Hess Corporation Stock Comparison*, NASDAQ, http://www.nasdaq.com/symbol/hes/stock-comparison (last visited Apr. 15, 2014).
[132] *Id.*
[133] *Elliott Management Files Proxy Materials for Hess Shareholders*, BUS. WIRE (Apr. 4, 2013, 8:32 AM),

Wanting to remedy the problem, Elliott Management nominated five candidates for Hess's fourteen-member board, hoping to gain more control over the corporation's strategy and increase profits.[134] Elliott Management offered to compensate these candidates, once through the corporation and again through the hedge fund pursuant to one condition: substantial increases in shareholder and corporate value.[135] The proposed compensation was generous. Elliott offered each director-nominee $50,000 to run and an additional $30,000 per percentage point Hess's stock price outperformed its competitors' prices.[136]

Jana Partners also made headlines in its proxy battle with Agrium, Inc. Jana Partners acquired a 7.5% interest in the Canadian-based agricultural supply company prior to the battle that ensued.[137] Like Elliott Management's contention with Hess, Jana Partners claimed Agrium was not reaching its potential. In this case, Jana Partners "contends Agrium has underperformed its peers by 160% over the last five years."[138] Jana Partners decided to nominate five directors to Agrium's twelve-member board.[139] Its golden leash, unlike Elliott Management's, offered the nominees additional compensation *based on the hedge fund's performance*. As such, Jana Partner's nominees stood in line for substantial profits that had the potential to dwarf the compensation Elliott Management offered.[140] The Jana Partners nominees each received $50,000 along with 2.6% of the hedge fund's net profits derived from increases of Agrium's share price.[141]

Both Elliott Management and Jana Partners' bonus compensation proposals fell through.[142] Elliott Management nonetheless gained three of the five sought-after board seats.[143] Jana Partners was not successful in

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http://www.businesswire.com/news/home/20130404005734/en/Elliott-Management-Files-Proxy-Materials-Hess-Shareholders#.Uydx4tyaLwI.

134 *See* Matthew Rocco, *Elliott Nominates 5 to Hess Board*, FOX BUS. (Jan. 29, 2013), http://www.foxbusiness.com/industries/2013/01/29/elliott-nominates-5-to-hess-board/.

135 *See* Steven M. Davidoff, *Upping the Ante in a Play for a Stronger Board*, N.Y. TIMES DEALBOOK (Apr. 2, 2013, 6:31 PM), http://dealbook.nytimes.com/2013/04/02/upping-the-ante-in-a-play-for-a-stronger-board/?_php=true&_type=blogs&_r=0.

136 *Id.*

137 *Id.*

138 *Id.*

139 *Id.*

140 *See id.*

141 *Id.*

142 David Gelles, *A Debate over Paying Board Nominees of Activist Funds*, N.Y. TIMES DEALBOOK (Nov. 25, 2013, 9:24 PM), http://dealbook.nytimes.com/2013/11/25/a-debate-over-paying-board-nominees-of-activist-funds/?_r=0.

143 Michael J. de la Merced, *How Elliott and Hess Settled a Bitter Proxy Battle*, N.Y. TIMES DEALBOOK (May 16, 2013, 9:11 AM), http://dealbook.nytimes.com/2013/05/16/hess-and-elliott-settle-fight-over-companys-board/.

earning any board seats.[144] Importantly, the hedge funds' proposals drew criticism as "the prospect of such incentives upset the stuffy world of corporate governance. And the simmering dispute around director compensation from third parties is the latest front in the growing war of influence being waged between activist hedge funds and corporate boards."[145] At first glance, the proposed bonuses might not appear controversial since the hedge-fund-backed directors only receive additional compensation if the company's "stock rose sharply"[146] (or, in Jana Partner's case, the hedge fund's value increased). The investment world, however, was all but silent.

As mentioned, the issue is myopic versus non-myopic corporate strategy implemented by these new directors. Simply put, hedge-fund-backed directors have a real incentive to advocate for more short-term direction in an effort to boost stock price quickly.[147] Corporations worry that golden leashes, as explained, will seek only short-term profits, cut all ties to the corporation and then run to the nearest bank. These directors, for instance, can opt to sell off the corporation's assets or promote the disbursement of excessive dividends.[148] In either case, as the argument goes, the corporation's long-term health is jeopardized because lower cash holdings can affect the corporation's stability. These cash reserves could be used to reinvest in the corporation via research and product development.

An additional argument against golden leashes exists. The fear is that hedge-fund-nominated directors would remain partial to the hedge fund after a successful election. Corporations fear their independence would be jeopardized because of the compensation packages provided by the hedge fund. Partiality, as might be imagined, produces the risk that hedge fund directors will engage in strategies that are beneficial to the hedge fund but detrimental to the corporation (such as the myopic strategies discussed above).[149] On the other hand, Jana Partners points to contract law. As the hedge fund agreed to the package, it could not back out of the agreement.[150] Therefore, the nominees are not "beholden to the hedge fund."[151]

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[144] Ben Dummett & Chester Dawson, *Agrium Defeats Jana Bid for Board Seats*, WALL ST. J. (Apr. 9, 2013, 5:46 PM), http://online.wsj.com/news/articles/SB10001424127887324050304578412881933919870.
[145] Gelles, *supra* note 142.
[146] *Id.*
[147] *See* discussion *supra* Part III.D.
[148] *See* discussion *supra* Part III.D.
[149] *See* discussion *supra* Part III.D.
[150] Davidoff, *supra* note 135.
[151] *Id.*

VI. EXPLORATION OF THESIS

1. *Defenses Against Shareholder Activism*

Implementing bylaws prohibiting activists from nominating and paying directors would be an unnecessary step at this point in time. Certain defenses are already available to a target corporation. For example, corporations may insulate board members by creating a staggered board.[152] Staggered boards prevent shareholders from removing a majority of the board at any given time.[153] Thus, majority shareholders can ward off tumultuous minority uprisings through corporate governance structuring at one proxy vote. It has been argued, "the staggered board thus serves as a powerful antitakeover device and 'entrenches' the board, unduly protecting it from shareholder influence. Directors will instead look out for themselves and management instead of shareholders."[154]

These boards, however, are becoming less prevalent—at least for companies that are already public.[155] Nonetheless, the option does remain for entrepreneurs who are taking their company public. In fact, "[a]ccording to FactSet SharkRepellent, 86.4 percent of the companies going public [in 2012] had a staggered board."[156] Companies going public have even written provisions into their bylaws requiring an eighty percent vote to remove the staggering structure.[157] A corporate governance provision such as this makes it much more difficult for hedge fund activists to gain a substantial amount of board influence.[158] At least in theory, entrenching the board of directors makes it much more difficult for activists to exert their power.[159] Directors should be less susceptible to outside influence if they enjoy a fair amount of future stability as a member of the board.[160] More of these anti-takeover defenses exist, rendering the bylaw in question an unnecessary change at this time.[161]

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[152] *See generally* Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002).
[153] *See generally* Alma Cohen & Charles C.Y. Wang, *How Do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment* (Harvard Bus. Sch. Working Paper No. 13-068, 2013), *available at* http://www.hbs.edu/faculty/Publication%20Files/13-068_f53b491e-9847-4ccb-8cb5-8e75808bc39f.pdf.
[154] Steven M. Davidoff, *The Case Against Staggered Boards*, N.Y. TIMES DEALBOOK (Mar. 20, 2012, 12:43 PM), http://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards/?_r=0.
[155] *See id.*
[156] *Id.*
[157] *Id.*
[158] *Id.*
[159] *Id.*
[160] *Id.*
[161] A few examples of such defenses include: purchasing stock through a tender offer, purchasing stock in the open market and two-tier voting.

Martin Lipton provides a more in-depth strategy to ward off hedge fund activists.[162] Lipton advises the target to create a team of two to five officers, a lawyer, investment banker, proxy-soliciting firm and a public-relations firm to deal with the activist.[163] The team should continuously engage in meetings and become familiar with the types of activism usually employed by the hedge fund.[164] Among other things, Lipton advises the target's board and the team to oversee shareholder relations, review its capital return policy and "[p]roactively address reasons for any shortfall versus peer company benchmarks; anticipate key questions and challenges from analysts and activists, and be prepared with answers."[165]

Regardless of the defenses, the debate about bylaws prohibiting hedge funds from directly compensating their directors continues. Recently, three directors at Provident Financial Holdings Inc. voted to approve these bylaws prohibiting the golden leash.[166] Unsurprisingly, activists involved in Provident Financial are currently calling out those three directors and are hoping to vote them out.[167] The golden leash critics claim activist-bonus payments paid to directors compromises their independence by aligning them with the shareholders paying such fees—namely, the hedge funds themselves.[168] Wachtell, Lipton, Rosen & Katz LLP (Martin Lipton's firm) released a memo enumerating specific threats caused by the golden leash.[169] The memo noted that these compensation arrangements pose a number of threats, including:

- undermining Board prerogatives to set director pay and select the timeframe over which corporate goals are to be achieved;
- creating a multi-tiered, dysfunctional Board in which a subset of directors are compensated and motivated significantly differently from other directors;
- creating economic incentives to take the corporation in the specified direction, and within the timeframe, that would trigger outsized compensation, whether or not

[162] *See generally* Lipton, *supra* note 8.
[163] *Id.* at 2.
[164] *Id.*
[165] *Id.*
[166] David Benoit & Joann S. Lublin, *'Golden Leash' Payments Fuel Debate*, WALL ST. J. (Nov. 26, 2013, 2:59 PM), http://online.wsj.com/news/articles/SB10001424052702304281004579220094112755708?cb=logged0.5917782397009432.
[167] *Id.*
[168] *Id.*
[169] Martin Lipton, *Bylaw Protection Against Dissident Director Conflict/Enrichment Schemes*, HARVARD L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 10, 2013), https://blogs.law.harvard.edu/corpgov/2013/05/10/bylaw-protection-against-dissident-director-conflictenrichment-schemes/.

doing so would be in the best interests of all shareholders, would engender inappropriate and excessive risk, or would sacrifice long-term value for short-term gain;

- opening a schism between the personal interests of directors who stand to benefit in the short-term from the special compensation scheme and the interests of shareholders with a longer-term investment horizon;
- creating poisonous conflicts in the boardroom by creating a subclass of directors who have a significant monetary inventive to sell the corporation or manage it to attain the highest possible stock price in the short-run;
- and introducing unnecessary and problematic complexity and conflicts in strategic reviews and calling into question those directors' ability to satisfy their fiduciary duties.[170]

According to the memo, Columbia School of Law Professor John C. Coffee, Jr. wrote that "third-party bonuses create the wrong incentives, fragment the board and imply a shift toward both the short-term and higher risk," and UCLA Professor Stephen Bainbridge concurred, saying, "[I]f this nonsense is not illegal, it ought to be."[171] The memo further provides specific language for a bylaw:

> No person shall qualify for service as a director of the Corporation if he or she is a party to any compensatory, payment or other financial agreement, arrangement or understanding with any person or entity other than the Corporation, or has received any such compensation or other payment from any person or entity other than the Corporation, in each case in connection with candidacy or service as a director of the Corporation; *provided* that agreements providing only for indemnification and/or reimbursement of out-of-pocket expenses in connection with candidacy as a director (but not, for the avoidance of doubt, in connection with service as a director) and any pre-existing employment agreement a candidate has with his or her employer (not entered into in contemplation of the employer's investment in the Corporation or such employee's candidacy as a director), shall not be disqualifying under this bylaw.[172]

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[170] *Id.*
[171] *Id.* (internal citations omitted).
[172] *Id.* (emphasis in original).

Notably, this suggested bylaw does not prohibit hedge fund activists from nominating directors, nor does it prohibit hedge funds from indemnifying and reimbursing directors for any campaign costs.[173] Wachtell's bylaws seem to allow for the more "customary compensation"[174] structures hedge funds typically create. Examples of these acceptable compensation arrangements include those paid by Glenview Capital Partners LP and Starboard Value LP. These hedge funds paid director-nominees $100,000 and $20,000, respectively.[175] Starboard Value's nominees used the cash to purchase stock in the corporation itself.[176]

The memo concludes by encouraging corporations to adopt this prophylactic measure.[177] Around "twenty-six companies have adopted bylaws" closely mirroring the language contained in Wachtell's memo, including Provident Financial.[178] Interestingly, Institutional Shareholder Services (ISS), the largest U.S. proxy adviser, recommended that shareholders oppose the reelection of the three Provident Financial directors that voted to adopt the anti-golden leash bylaws.[179] ISS's recommendation to oppose those directors is good news. It exemplifies the hesitancy warranted given the potential consequences. According to Patrick McGurn, ISS's special counsel, ISS also disagreed with the fact that Provident implemented the bylaw without shareholder approval and because the board failed to present a compelling explanation.[180]

However, until quantitative evidence emerges showing a negative correlation between activism and long-term corporate health, the bylaw itself poses a problem that may outweigh its benefits. It *is* inarguable that golden leashes provide great economic incentives to directors. But such incentives are not necessarily all negative. Indeed, these golden leashes can bring in competent directors otherwise unwilling to take on the headaches inevitably involved with sitting on a corporation's board.[181]

This point is simple and capitalistic to its core. Arguably, the most competent people with the greatest experience and knowledge are likely highly-paid businesspersons. As these businesspersons are likely already overworked and overstretched, there needs to be a significant incentive to

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[173] *Id.*
[174] Benoit & Lublin, *supra* note 166.
[175] *Id.*
[176] *Id.*
[177] *See* Lipton, *supra* note 169.
[178] Benoit & Lublin, *supra* note 166.
[179] *Id.*
[180] *Id.*
[181] *See* Brandon S. Gold, *Why the Wachtell Bylaw on Director Compensation by Shareholders is Overbroad and May Fail Blasius Scrutiny*, CLS BLUE SKY BLOG (May 31, 2013), http://clsbluesky.law.columbia.edu/2013/05/31/why-the-wachtell-bylaw-on-director-compensation-by-shareholders-is-overbroad-and-may-fail-blasius-scrutiny/ ("It is well known that recruiting highly qualified directors is a challenge.").

put in the extra hours a board membership requires. What better incentive is there than additional monetary compensation? According to *The Wall Street Journal*, ISS was wary that "the Provident bylaw and the broad restrictions on compensation could lead to the exclusion of high-quality individuals from the board."[182] It is worth noting that, to date, ISS has not formally issued its stance on golden leashes.

Additionally, the golden leash compensation is tied into *positive* corporate performance so the directors are only additionally compensated if the target corporation performs well. Because the most conclusive quantitative data available indicates that hedge fund activism results in positive corporate performance, these bylaws could inhibit the economic growth they are seeking to protect.[183]

Keeping in mind that, currently, no substantial quantitative data exists suggesting that hedge fund activism is poisonous for corporate America, it seems plausible that bylaws prohibiting these golden leashes could do more harm than good. Indeed, as mentioned, simply announcing a shareholder activist has taken a stake in the target company produces approximately a six percent increase in stock price.[184] Additionally, the Bebchuk, Brav and Jiang data found that target corporations also enjoy long-term value at least five years after the initial stake.[185] As the most conclusive data available to date, the Bebchuk, Brav and Jiang findings should be given significant credence.

As it appears shareholder activity positively affects target companies in both the short- and long-term, it would be imprudent to implement the bylaws without further investigation. Given that the most conclusive econometric analysis weighs heavily in favor of shareholder activism, placing undue obstacles in the way could unnecessarily negatively affect capital markets. For these reasons, corporations should resist adopting the Wachtell, Lipton, Rosen and Katz bylaw. Adoption of the bylaw should only occur if and when more conclusive econometric analysis reveals hedge fund activism reduces a target corporation's long-term value.

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182 Benoit & Lublin, *supra* note 166.
183 *See supra* Part III.E.
184 Bebchuk, *supra* note 12, at 16.
185 *Id.* at 37.